

ARGUMENTS AGAINST MUDĀRABAH MODEL IN *TAKĀFUL* INSURANCE

Journal of Social Review
Volume 3 (1)
December 2014
Department of
Social Sciences

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Abstract

Takāful is an alternative Shari'ah compliant mechanism for conventional insurance system, practiced in several countries in the world. As it is a new innovation in the insurance business it has some Shari'ah jurisprudential issues in its some segments when it comes into application. It has several models in practice namely Ta'āwuni, Mudārabah, Wakālah, Hybrid and Waqf. In this connection, I intend to look into the issues of Mudārabah model under the light of Al Qur'ān and Al Sunnah with the ideas of eminent scholars in this field as it contravenes few Shari'ah and legal principals. In addition to that, I tried to search into this issue. At the end, I forwarded some ideas and solutions for the issues.

INTRODUCTION

Islam is a global phenomenon and its influence on society and economy is ubiquitous. In Africa, Islam is the most dominant religion and over 52 percent of the population is Muslims. In Asia, where over 32 percent of population abide by Islamic principles. Muslims also comprise approximately 8 percent of the European population. All in all, 1.97 billion Muslims live in 184 different countries, comprising about 29 percent of world population in 2011 (www.muslimpopulation.com/world). In the US, the number of Muslims has grown from mere 10,000 in 1900 to over 1 million in 2000 and 6 million in 2010 (New York Daily News, 3rd May 2012).

As the true religion of Allah, the most merciful, Islam has to provide guidance in every sphere of life. This guidance is not limited to the spiritual and social aspects but also covers economic dimension of

human life. Islamic economic system supports interest free financial system. And also commands the human beings to commercial transaction with justice and honesty. It directs the people right path in financial matters.

All human beings are invariably exposed to the likelihood of meeting catastrophes and disasters giving rise to misfortunes and sufferings such as death, loss of limbs, accident, destruction of business or wealth, etc. Notwithstanding belief of all Muslims in Allah and *al Qadā' wa al Qadr*, Islam provides that one must find ways and means to avoid such catastrophe and disaster wherever possible, and to lighten his or his family's burden should such event occur. One possible resort in this contest is insurance cover as available in the conventional system. The eminent jurists, scholars and researchers have invented *Takāful* Islamic insurance

based on *Al Qur'ân*, *Al Sunnah* and related sources of Islamic jurisprudence as an alternative for prevailing insurance system. In other way, as Munawar Khan, M., Naveed Ahmad, Iqbal, M.S. and Salmat Ali (2011, p.286) say that the Muslims all around the world wish to go side by side with modern commerce. They are not willing to follow non-Islamic practices. They are looking for Islamic alternatives to prevailing financial instruments and practices. Islamic banking is a great success not only in Muslim majority but also in Muslim minority countries. Major international banks are today offering *Shari'ah* compliant products. In the similar manner *Takâful* presents an Islamic alternative to insurance.

This Islamic insurance system is being practiced in Muslim countries as well as in countries which the Muslims live in as a minority community. It is getting more popularity among Muslims as a *Halâl* product and among non-Muslims as a reasonable and ethical transaction system. If they see that the results of the investments are good, and that it is not involved with gambling, alcohol, and interest, they feel comfortable with these principles. According to Zurni Zainul Abidin (2012), an agent for *Takâful* National Malaysia, *Takâful* National has 500,000 individual policy holders and 20 per cent of its participants are non-Muslims and they are seem to be more interested in obtaining policies from *Takâful*.

LITERATURE REVIEW

Several scholars have written about this subject in their literature. For instance, Essential Guide to *Takâful* (Islamic Insurance) by Engku Rabiah Adawiah and Hassan Scott, *Takâful* and *Retakâful* ó Advanced Principles & Practices by Tobias Frenz and Younes Soualhi, Fundamentals

of *Takâful* by Mohamed Fadzli Yusof, Wan Zamri Wan Ismail and Abdul Khudus Mohamed Naa'im, Basis and Models of *Takâful*: The need for *Ijtihâd* by Mortuza Ali, Comparative Analysis of Islamic and Prevailing Insurance Practices by Munawar Khan, Naveed Ahmad, Iqbal and Salmat Ali, *Shari'ah* Issues in *Takâful* by Shahrul nizam, An Analytical Study of the Potential of *Takâful* Companies by Syed Umar Farooq, Tariq Saeed Chaudhry, Fakhr-e-Alam and Ghayur Ahmad.

But they did not focus their views on the matter itself. Some explained the subject in detail. Meanwhile others briefed it with other subjects. I tried to focus the issue and explain it clearly with the views of the eminent scholars in the field, offering some alternatives for the issues.

RESEARCH METHOD

This work is based on secondary data. Secondary data has been collected from several sources. Relevant literature has been gathered from a number of books. Extensive data has been collected through websites and database articles. To receive objectives of the study information work by different authors and organization have been used. We have used secondary data most of which is in English. Findings and conclusion achieved by analyzing the collected data.

OBJECTIVES

To elaborate the *Mudârabah* model of Islamic insurance

To evaluate the *Mudârabah* model of *Takâful* insurance on the basis of its jurisprudential issues

To offer alternative solutions for the issues related to *Mudârabah* model

WHAT IS *TAKÂFUL*?

Takâful (تَكَافُل) is an Arabic word derived from the root-word *ṭKafala* (كَفَلَ) a verb, which means guarantee, responsibility, assurance, bail, warrant or an act of securing one's need. In this connection, meanings of *Takâful* as an Arabic word are joint guarantee, assuring each other, joint benefit, shared responsibilities, mutually guaranteeing and mutually caring for one another.

In the context of Islamic insurance, *Takâful* refers to an arrangement for mutual indemnity in providing protection and compensation to the participants who suffered from perils and hazards.

According to section 2 of the Malaysian *Takâful* act 1984: *ṭTakâful* is a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants, in case of need whereby, the participants mutually agree to contribute for that purpose.

The Accounting, Auditing and Governance Standards for Islamic Financial Institutions (2004/05) provides: *ṭIslamic insurance is a system through which the participants donate part or all of their contributions which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions.*

The AAOIFI's *Shari'ah* Standard (2007) provides: *ṭIslamic insurance is an agreement between persons who are exposed to risks to protect themselves against harms arising from the risks by paying contributions on the basis of commitment to donate (iltizâm bi al-tabarru'). Following from that, the*

insurance fund is established and it is treated as a separate legal entity (*shakhsiyyah I'tibâriyyah*) which has independent financial liability. The fund will cover the compensation against harms that befall any of participants due to the occurrence of the insured risks (perils) in accordance with the terms of policy.

The Islamic Financial Service Board (IFSB) and International Association of Insurance Supervisors (IAIS) give the following description: *ṭTakâful* is the Islamic counterpart of conventional insurance, and exists in both life (and family) and general forms. It is based on concepts of mutual solidarity, and a typical *Takâful* undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company (Engku Ali, E.R.A. and Odierno, H.S.P., 2008, pp. 3,4).

Bank Negara Malaysia, in its website has interpreted *Takâful* as follows; *ṭTakâful* (Islamic insurance) is a concept whereby a group of participants mutually guarantee each other against loss or damage. Each participant fulfills his / her obligation by contributing a certain amount of donation (or *tabarru'*) into a fund, which is managed by a third party - the *Takâful* operator. (Shahrulnizam, p. 7).

When we think about what are the causes behind the originating insurance as well as *Takâful*, there will be a historical background for that. According to Syed Umar Farooq, Tariq Saeed Chaudhry, Fakhr-e-Alam and Ghayur Ahmad (2010, p.55) the background and reasons for emergence of insurance as well as *Takâful* particularly are as follow: The old order has given place to new and the agrarian society has been transformed into a modern industrial society. The process of industrialization has been so rapid that it may rightly be described, as the revolution. This revolution did not eliminate the chance

of loss of life and property. The development in transportation industry, the increased use of machinery, all these are followed by risks like accidents, hazards and injuries. To mitigate the seriousness of their consequences and to cover the chances of loss insurance is pressed in to services to such an extent that this institution has become an essential of the modern life and its influence can be traced in almost all spheres.

Some of the important legal and socio-economic institutions, which have developed in the west during the last four hundred years and have left strong impacts on the Muslim society, are their present forms and structures. Islam enunciates the conflict with values and principles. The course of history has forced these institutions and organizations over Muslim society. Muslim scholars and economists are becoming more and more conscious of this conflict and applying themselves to task of wittingly the Muslim society. To achieve this purpose, it is necessary that the objective study of the contemporary institutions and the law of Islam should be made and then attempt to develop the alternate socio-economic system, which can fulfill Muslim need without violating the fundamental principles of Islam. One of the measures adopted in modern times for the institutions of economy and finance is insurance. It has a key role in present industrial development as well as in large-scale organization of commerce, industry, agriculture and individual daily business.

Muslims regard the resources of various kinds in this world as the gift of Allah, which have been given as a trust in the hand of mankind, to utilize them in most efficient manner aiming to produce the maximum output. There is a continuing surge of commitment to revive of Islamic way of life. The reorganization of finance and economy

is part of that commitment and involves tackling the problems of daily life. Muslims ardently desire to adopt institution, which will further advance them to forefront of the modern world.

All theories and practices covered by the established field of economic are examined from Islamic laws and values as enshrined in the *Al Qur'ân* and the *Al Hadîth* (report of the sayings or actions of Muhammad or his companions). The economic activities, which are permitted by *Shari'ah*, are studied under the Islamic economics, which does not support either capitalism or socialism. These principles are based mainly on the prohibition of interest (*ribâ*), engaging in permissible (*halâl*) dealing, and avoiding Prohibitive (*harâm*) dealing, Prohibition of entering into contracts containing uncertainty (*gharar*) or speculation or Gambling (*maisir*) and Payment of *Zakâh*. Muslim must also rely on Allah's destiny (*Taqdîr*) or dependent (*Tawakkul*) of Allah for his subsistence and security.

Takâful or Islamic Insurance is basically based on the concept of mutual or cooperative insurance and it takes care of all the *Shari'ah* related concerns including ensuring investment to be made in *Shari'ah* compliant instruments. The concept of *Takâful* as such is not new in Islamic commercial law. Islam accepts the principle of reciprocal compensation and joint responsibility. The system of *Takâful* insurance tends to achieve self-reliance through a self-sustaining insurance system based on community pooling, solidarity and joint guarantee for the wellbeing of community and individuals in need, the entire system and operation being based on Islamic principle. (Qaiser, p.4)

As Ramin Cooper Maysami and W. Jean Kwon (p.7) describe on how the *Takâful* insurance is being practiced. *ôTakâful*

insurance refers to an Islamic way of joint guarantee in which a group of societal members pool their financial resources together against certain loss exposures. In particular, *Takâful* life insurance works both as (1) a saving instrument where participants set their own target amount to accumulate over a certain period, and as (2) a protection mechanism in which all participants guarantee each other against certain events that would alter their financial status. In contrast, *Takâful* non-life insurance works more like a joint guarantee in which all participants contribute their own shares of premiums into a pool and mutually agree to indemnify those participants who suffer from an insured peril. Muslim jurists generally agree that *Takâful* insurance is accordant with the *Shari'ah*, as *halâl* concepts of *tabarru'* (meaning 'donation' or 'contribution') and *Takâful* (meaning 'joint venture' or 'shared responsibility') are deeply embedded in it.

TAKÂFUL MODELS

Basically, there are two main systems in the *Takâful* operational model. One is the purely non-commercial (*ta'âwun*) *Takâful* system. In this cooperative system all participants mutually agreed to manage their *Takâful* fund themselves. There is no external interference or management in this arrangement. They are guaranteeing each other with the *Takâful* fund, sometime, they may engage in commercial activities within themselves. This method is similar to the traditional mutual companies. Generally, Regulatory and legal issues and complexities are lower than the operations with commercial aspects. Nevertheless, this method can be operated in a community, where the participants are capable, conscious and knowledgeable about operational parts of insurance. And also there should be funds available to start the venture. Moreover, the government support

too needed to run the business continuously. This system has been used mostly in Sudan.

According to K.M. Mortuza Ali (2006), "Many Islamic scholars suggest that purely cooperative or mutual form of insurance can be the basis of Islamic insurance. In cooperative model, the management and control are in the hands of the members, who are also the policy holders. The insured and the insurers are the same people. The only purpose of such a model is mutual protection and security. There is no element of profit. Surplus, if any, needs to be ploughed back into the insurance fund. Contributions of the participants may also be increased or decreased as per experience of the operation of the scheme."

E.R.A. Engku Ali and H.S.P. Odierno (2008, p. 43) say that the pure cooperative model is one where the operations and profits are completely self-contained. There is little room for entrepreneurial spirit here and there are significant difficulties in raising capital. The model is normally used by government-backed *Takâful* operations to meet the specific needs of people in the country.

The other one is commonly commercial (*tijâri*) *Takâful* system. In this system there are various, different models have evolved and are being practiced over the years. For instance: *Mudârabah* model, *Wakâlah* model, Hybrid model and *Waqf* model. Whatever the mode of operation, there should be some basic elements, such as cooperation and mutuality, accountability, transparency and lawful in *Shari'ah* concern.

In this regard, there are some criticisms and arguments on the concept and operation of *Mudârabah* model in Islamic insurance business. As it is the main theme of this research paper, I will focus the matter directly as below:

MUDÂRABAH MODEL

Basically, in Islamic transactional law, the *Mudârabah* (مُدَارَبَة) means: one person gives an amount of money to another person who will engage in trading with the given capital for the purpose to share the profits gained according to a pre-agreed ratio or percentage. Currently, this system is widely used by Islamic banks. The *Takâful* operators also utilize this system for their investment venture.

In this *mudârabah* model, the *Sharî'ah* committee generally approves the sharing ratio for each year in advance. The sharing of such profit (surplus) may be in a ratio of 5:5, 6:4, 7:3, etc. Generally, these risk-sharing arrangements allow the *Takâful* operator to share in the underwriting results from operations, as well as the favourable performance returns on invested premiums (Shakun Ashoka Raj, 2007, p.86).

In this model, the main aim of participants is not *mudârabah*. It is their secondary objective. Therefore, the family *Takâful* operators divide the contributions into two sets, namely participants' account (*tabarru'*) and participants' account (*mudârabah*). Further, Waheed Akhter (2010, p.3) describes that in family *Takâful* plan, Participants' contribution is divided into two parts. The major portion of the fund goes into Participants' Account (PA) that belongs to participant whereas smaller portion is contained in Participants' Special Account (PSA) that is used to pay claims and underwriting costs. Entire amount of PA and PSA is invested in *Sharî'ah* approved instruments. Profit from PA is shared between participants and *Takâful* operator according to agreed ratios.

Profit and the amount in PSA are used to pay for claims and underwriting costs. In case, claims payments and underwriting

costs exceed the amount prescribed in PSA, the loss is compensated from PA or shareholders may provide interest free loan (*qard-e-hasan*). In case, claims and underwriting costs are less than the amount available in PSA, the amount left is treated as underwriting surplus and shared between *Takâful* operator and the participants. In *Mudârabah* model, *Takâful* operator claims to share in underwriting surplus as an incentive for efficiently managing *Takâful* funds.

In general *Takâful* plan, there is no PA A/C and participants' contribution goes directly to PSA that may be invested and is used to pay for underwriting costs and claims. A portion of PSA fund after taking into account profit from investment can be retained as contingency reserve for future. Any amount left is treated as underwriting surplus and is shared among participants and *Takâful* operator according to agreed ratios.

E.R.A. Engku Ali and H.S.P. Odierno (2008, pp. 33,34) explain the *Mudârabah* model that in the context of *Takâful* operation, it is observed that initially, money had been contributed by the participants for their mutual benefit and protection. In this sense, the *Takâful* fund can be construed as belonging to the *Takâful* participants collectively. Once the money had been contributed by the participants into the *Takâful* fund on the basis of *tabarru'*, the participants then appoint the *Takâful* operator to be their manager by way of *Mudârabah* contract to invest any available funds before and after payments of claims and other expenses (as and when they occur). The investment of the *Takâful* fund in this manner is to allow the fund to grow, rather than leaving it idle while waiting for claims or other expenses.

More specifically, when the participants enter into the *Mudârabah* contract with *Takâful*

operator, the participants collectively become the capital provider (*Rabb al-mâl*). The capital is the *Takâful* fund, which had been contributed by the participants by way of *tabarru'*. The *Takâful* operator becomes the manager (*Mudârib*) to invest the fund in a *Shari'ah* compliant manner and in accordance with the terms of the *Mudârabah* contract. If there is any profit made, it is to be shared between the participants and the *Takâful* operator based on the pre-agreed ratio or percentage. On the other hand, any losses are solely borne by the participants as capital providers (except in cases of negligence or fraud of the manager).

Moreover, Mohamed Fadzli Yusof, Wan Zamri Wan Ismail and Abdul Khudus Mohamed Naaim (2011, p. 34) elaborate that profit in *Takâful* is defined as returns on the investment and surplus from the underwriting in respect of the *Takâful* funds only. Therefore, this does not include profit posted by the shareholders' fund. For the family business it includes the mortality surplus to be allocated to the eligible participants as declared by the actuarial valuation at the end of every financial year. However, unlike the *mudârabah* contract in Islamic banking product, profit sharing in *Takâful* will be undertaken only after all the obligations of *Takâful* have been accounted for: the biggest factor is claim. In the event of a loss or deficit of the *Takâful* fund, the loss will be borne wholly by the participant (s) as provider of capital.

An important feature to note is that under the *mudârabah* model, management expenditure is not charged on the *Takâful* fund instead it is borne by the shareholders' fund. Revenue of the latter is its portion from the profit sharing of the *Takâful* funds with the participants, and all returns on the investment of the shareholders' fund itself (Mohamed Fadzli Yusof, Wan Zamri Wan

Ismail and Abdul Khudus Mohamed Naaim, 2011. pp.34 and 35).

Further, E.R.A. Engku Ali and H.S.P. Odierno (2008. pp. 43, 44) say that this is one of the earliest models of *Takâful* operation, especially in Malaysia, during the initial phase of the introduction of *Takâful* business in the country. The *Mudârabah* model is also known as the 'profit sharing model'. Two versions were generally developed. One included only investment profit sharing (sometimes called 'pure *Mudârabah*'); and another which also included the sharing of underwriting surplus. (Sometimes called 'modified *Mudârabah*')

According to K.M. Mortuza Ali (2006. P.3) at present, there are three different systems of *Mudârabah* mechanism. Some of the companies follow a pure *Mudârabah* system, where the participants and the operator share direct investment income. Underwriting surplus, if any, is distributed entirely to the participants only. Some companies follow a practice of sharing surplus of the fund, and profit from investment is ploughed back to the fund. A third practice is to share both the surplus and the investment income between the operator and the participants.

With regard to the eligibility of participants in the share of the surplus, there are two different approaches. Some are of the opinion that participants will be eligible to participate in the distributable surplus, provided they have not made any claims or received any *takâful* benefits from the operator, or if they have surrendered/terminated policies. Others feel that the participants are eligible to the share of surplus if the claim is less than the contribution.

It should however be noted that there are some variations in the treatment of underwriting surplus by some *Takâful* operators in Malaysia, especially in the

earlier practices of *mudârabah* operational model. In this type of *mudârabah* model, the underwriting surplus is construed as *‘mudârabah profits’* to be shared between the participants and the *Takâful* operator.

This arrangement is termed by some as *‘modified mudârabah model’*, as opposed to the *‘pure mudârabah model’* where there is no sharing of underwriting surplus with the *Takâful* operator.

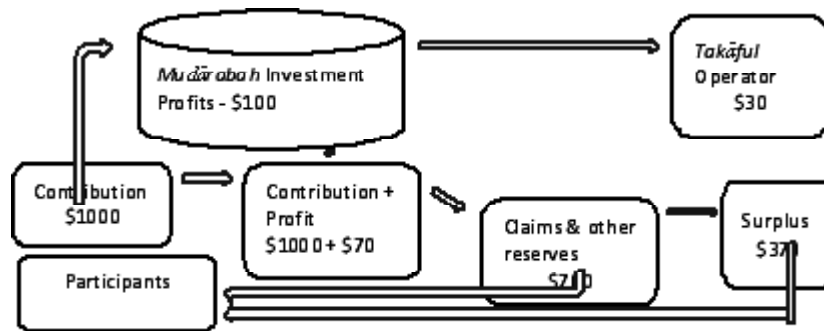


Diagram 1 – Pure *Mudârabah* Model

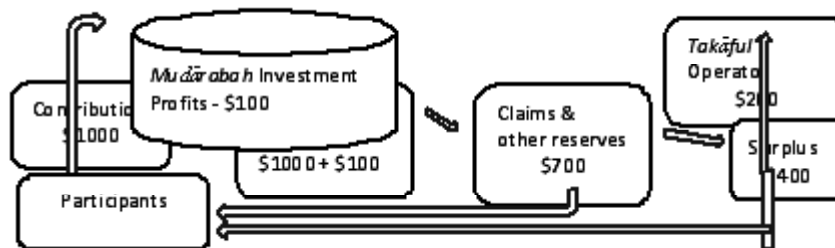


Diagram 2 – Modified *Mudârabah* Model

Here, the underwriting surplus is shared with the operator. This model was a necessary adaptation of the pure *mudârabah* model at the time due to certain products such as group *Takaful*, yearly riders, and general *Takâful* having very little savings element, thus making a pure *mudârabah* model not feasible.

Under a pure *mudârabah* model, if there is a loss, the *rabb al mâl* loses (some of) his capital and the *mudârib* loses in terms of effort. Therefore, the modified *mudârabah* model is not really *mudârabah*, and that is why some scholars, especially in the Middle East do not condone it.

ARGUMENTS AGAINST THE *MUDÂRABAH* MODEL

There are some *Sharî'ah* issues raised by some Islamic scholars regarding the operation of the *Mudârabah* system in the *Takaful* insurance. Notably Nizam Yacoubi and Abdul Satar Abu Ghuddah, as well as Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), have brought into question the use of a *Mudârabah* contract in a certain *Takâful* operations. The two main objections are there. One its use have been the intermingling of the participant's contribution from a *Tabarru'* and *Mudârabah* capital perspective.

Sharing of underwriting surplus leads *Takâful* into a commercial business venture instead of a contract of mutuality and joint protection. Other one is the fact that a *Takâful* or insurance operation creates surplus not profits and therefore the use of a profit sharing contract may not be appropriate. It is argued that donation cannot be profit sharing at the same time. It is important to note that under *mudârabah*, the *Taka-ful* fund belongs to the participants and not the *Takâful* operator. The *Takâful* operator therefore has no right to a share of the surplus.

Some others put forward some Islamic legal questions about this operation. For instance: A.W. Abdul Rahim, M.K. Lewis, and M. Kabir Hassan (2007, pp. 377-381), ask some valuable questions in this regard. "The basic objective is to pay for a defined loss from a defined fund, which is set up mutually by policyholders but is managed by a *Takâful* company. The contributions given are based on the principle of *tabarru'*. A *tabarru'* is a one way transaction in which once the contribution is paid, the contributor has no right to take any benefits out of it. Rather, the fund is used for any participant who faces financial difficulties or losses within the time period as agreed upon in the insurance policy. A number of issues arise.

First, there is a question whether all *Takâful* operators comply with the recommendation to accept *ta'âwun* (تعاون) as a basis for Islamic insurance. When people contribute their money, they are usually expecting something in return (i.e., financial reward or profit sharing). There is consequently a question mark regarding the true nature of *ta'âwun*. Is it really cooperative in nature? There are some operators using the cooperative insurance model, such as ICMIF London and NTUC Income Singapore, but they are rarities. While most

insurers/*Takâful* operators are described as the custodians or treasurers of the common fund, most of them are more than treasurers and, notwithstanding the words used, believe that they are actually the owners of the fund. Moreover, few of those who buy Islamic insurance are conscious that the premium is for mutual help.

Second, the relationship between the participants is one of *tabarru'* (donation) as defined in the contract and not of *Mudârabah* (profit sharing contract). It is therefore of concern to *Shari'*ah scholars that a profit-sharing contract should not be applied here, as a donation cannot be *Mudârabah* capital at the same time.

Third, in a *Mudârabah* contract, a profit is generated to be distributed (although there are the usual concerns as to cash or accrual basis for accounting). Essentially, an investment on a *Mudârabah* basis of 100 should at the end of the period give more than 100 to be termed as profit and for the operator to share in that. However, profit is not the same as surplus (excess of premiums over claims, reserves, and expenses), and in the insurance context, no profit can be generated by definition so the question of distribution of profit is of concern.

Nevertheless, the manner in which the *mudârabah* profits are calculated and derived in the so-called *modified mudârabah* model has been subjected to a number of criticisms. As depicted in diagram 2 above, the *mudârabah* profit sharing is based on the *net surplus* in the *Takâful* fund after payment of claims. The crux of the criticism against the practice centers around the definition of *mudârabah* profit and the issue of whether the *net underwriting surplus* can be treated as *mudârabah* profit or not.

Generally, *mudârabah* profit is defined as a surplus over and above the original capital

after deduction of costs and expenses. However, in this situation, there is usually no surplus over and above the original capital (which is the initial amount of contribution in the *Takaful* fund), because of the reduction due to claims or other expenses (e.g. re-*takaful* costs and reserves). What remains in the *Takaful* fund is just the *net underwriting surplus*, which is lower than the original capital, even after addition of any profit generated from the investment activities.

To illustrate the issue, say for example, the original amount in the *Takaful* fund of a particular scheme is \$5 million. This \$5 million is then used as *mudarabah* capital, which is to be managed by the *Takaful* operator. After investments, the *Takaful* fund gets a return of say 5% for the year. This is equivalent to \$250,000. The expenses for the year are say \$1 million; whilst total amount of claims are \$2 million. The calculation at the end of the year is as illustrated below:

Formula:

$$(\text{Original capital} + \text{profit}) - (\text{expenses} + \text{claims}) = \text{net return}$$

Simulation:

$$(\$5,000,000 + \$250,000) - (\$1,000,000 + \$2,000,000) = \$2,250,000$$

From the calculation above, it is clear that there is a reduction in the *mudarabah* capital from \$5 million to \$2.25 million at the end of the financial year. Thus based on the *mudarabah* contractual rules, there is no profit to be shared for the year because there is no surplus over and above the original capital amount; in fact. There is a situation of loss.

Nonetheless, from the conventional insurance understanding, the remaining \$2.25 million is considered as *net*

underwriting surplus and treated conventionally as *profit* to the insurance business. That is why, some *Takaful* operators who use *mudarabah* model tend to treat the *net underwriting surplus* as *mudarabah* profit and share the *surplus* with the participants based on the agreed profit sharing ratio. This practice of treating the *net underwriting surplus* as *mudarabah* profit has been criticized as not complying with the definition of profit in *mudarabah* and thus, not compliant with *mudarabah* rules generally. This controversy leads to the re-naming of the arrangement by some parties, from just *mudarabah* (or *pure mudarabah*) to *modified mudarabah*. This change of name is to reflect the different definition and treatment of *mudarabah* profit in the said *modified mudarabah* model (Engku Ali, E.R.A. and Odierno, H.S.P., 2008, pp. 44-49).

Mohd Shahrulnizam explains the above two issues in practice of *Mudarabah* model in Islamic insurance business. The first issue arises here is about the definition of the surplus. Under *Mudarabah* contract, surplus should be profit, and not the principal. Thus, the operator is entitled for the profit but not the remaining principal. What is happening in the market right now is that, the surplus is anything left after the total risk fund is deducted with claims, and it includes the balance principal.

The second issue is whether the *Takaful* operator is entitled for the surplus (as currently defined by the industry) distribution or not. Let us assume that the operator is using *Mudarabah* model for the Family *Takaful* product. If the *Takaful* operator use the *Mudarabah* model, it only entitle for the profit and not the principal amount. In addition, it must return the principal amount back to the participant, a process which not happens yet in the market. What is happening now is that, both the *Takaful* operator and

the participant share the profit (if any) and the principal amount. (Mohd Shahrulnizam Abd Hamid, pp. 18-20).

Whilst investment profits are clearly defined as excess return over invested capital, the same does not hold true for the underwriting profit. If that definition were applied, there would never be any underwriting profit, even if there were no claims (the return would then be zero, as it would equal the invested capital or contributions). Hence, it is technically correct to refer to underwriting surplus instead, i.e. the excess of contributions over claims and reserves.

Fourth, the sharing in underwriting surplus makes the contract essentially the same as conventional insurance contracts, where the shareholders become risk takers and therefore bear the risk and return from the underwriting results just as any ordinary business venture and not a contract for mutual assistance with a fee charged by the operators as risk managers.

Fifth, the requirement to provide a top-up interest-free *qard hasan* (قَرْدٌ حَسَنٌ) (in case of a deficit) in a *Mudarabah* contract by definition is against the concept of *Mudarabah* (even if this really is a *Mudarabah*), which is a profit-sharing contract, and the *mudârib* cannot be a guarantor.

Under a *mudârabah* model the participants as capital providers would have to bear the capital losses, i.e. through their contributions. The requirement for a *Takâful* operator to provide a *qard hasan* in event of an underwriting deficit (which is essentially a capital loss) is thus not a *Shari'ah* requirement. It was introduced for practical purposes and only to deal with temporary deficits that can be covered out of future surplus.

A capital loss under *Takâful* can far exceed the aggregate contributions of all participants. However even as *rabb al-mâl* (capital provider) their liability is limited to the capital outlay. The question then is who guarantees the claims payments under this model? If the *Takâful* operator as *mudârib* would provide an indemnification commitment, it would contravene the essential principals of *mudârabah* and would not be allowed under the *Shari'ah*. In practice though, there is a clear expectation by the participants that their claims will be paid in full, as is the case under conventional insurance. Hence, *Takâful* operators provide an implicit guarantee through the *qard hasan* promise. If the loan cannot be recovered, it will have to be written off partly or in full. This translates more or less to a guarantee by the operator. (Tobias Frenz and Younes Soualhi, 2010, pp. 142 and 143).

Under a pure *mudârabah* model, if there is a loss, the *rabb al mâl* loses (some of) his capital and the *mudârib* loses in terms of effort. Therefore, the modified *mudârabah* model is not really *mudârabah*, and that is why some scholars, especially in the Middle East do not condone it.

Sixth, because of a recognition that the application of the *Mudarabah* approach to risk sharing does not seem to be correct, most new operators are applying the *wakâlah*-based model as far as risk sharing is concerned (especially in the case of general *Takâful* and group family *Takâful*-type contracts where the investment element is not a part of the contract).

However, the view of scholars and Islamic jurists, in particular those who have been serving on the *Shari'ah* bodies of various *Takâful* operators in Malaysia, supporting the permissibility of the above model is based on the legal maxim where a ruling is decided based on the understanding

of the issue. In this regard, one of the approaches used is the principle of *'urf* as one of the secondary sources of *Shari'ah*. In *Shari'ah* resolutions in Islamic Finance published by Bank Negara Malaysia, *'urf* is defined:

As established norms and common to the majority of people in a community either in the form of sayings or doings. It is a common customary practice which is accepted and applicable as a legal basis of ruling as long it does not contradict the *Shari'ah* ruling. In the context of Islamic banking and finance, *'urf iqtisâdi* (a common business practice) is considered as a basis of *Shari'ah* rulings.

Guided by the above, the model recognizes contributions paid by participants as *ra'sul-mâl* and only in the event of a loss incurred on the donation contract on the basis of *tabarru'*. It is the *'urf* for General *Takaful* that the actual *tabarru'* cannot be determined at the inception of the contract until a loss occurs. Similarly, it is also the *'urf* that profit of the General Business includes underwriting surplus for which in the conventional operation it belongs to the shareholders. As the surplus forms part of the profit, under the *takaful* structure it will be subjected to profit sharing to enable the operator to pay for its management expenses and should there be any balance thereof to be declared as dividends to its shareholders. The transaction as a whole does not breach the doctrines of *'adl* and *ihsân* (Mohamed Fadzli Yusof, Wan Zamri Wan Ismail and Abdul Khudus Mohamed Naa'im, 2011. pp.38 and 39).

RESULTS

This study is a clear testimony to the fact that there are some *Shari'ah* legal issues in *Mudarabah* model of *Takaful* insurance in terms of its concepts and practices. Since

there are some other models with the compliance of *Shari'ah* as a replacement for *Mudarabah* model, it is recommended to adopt those models to operate Islamic insurance business.

As Said Bouheraoua and Muhammad Ali Jinnah Ahmad (2011. pp.16, 17) explain that under the *mudârabah* concept, two parties, basically the capital provider (*rabb al-mâl*), i.e., the participant, and the entrepreneur (*mudâarib*), i.e., the *Takaful* operator, operate on a joint-venture basis. The advantage of the *mudârabah* model is that operators have a bigger incentive to engage in efficient underwriting and strategically invest, as they will receive a portion of the surplus. A number of issues arise from the current practice of *mudârabah* model, however. Is the *mudârabah* model really cooperative in nature? Can the donation be considered *mudârabah* capital? Is the *mudârabah* profit the same as surplus? Can the shareholder share the underwriting surplus, as is the common practice in conventional insurance? In case of a fund shortfall, is the requirement of *qard* (interest-free loan) from the *mudâarib* in accord with the principle of *mudârabah*?

The issues and concerns about the applicability of *mudârabah* as an approach of risk sharing have driven some *Takaful* operators to adopt the *wakâlah* model and some other models.

This article gives a clear picture on *Mudarabah* model which has been practiced generally in Asia Pacific region of the world. In this way it is an addition to the literature on the subject and guidance for academics, researchers and practitioners to involve in further research in this field.

CONCLUSION

After reviewing the vitality of *Mudarabah* model, we found discrepancies that need

adjustments. Therefore, Mohd Shahrul nizam (pp. 18-20) suggests to *Takaful* operators to switch from *Mudârabah* to *Wakâlah-Ju'âlah* model, which possess lesser *Shari'ah*-compliance risk. Under *Wakâlah-Ju'âlah* model, a *Takaful* operator is entitled for a *Wakâlah* fee (i.e. Expense Fund (EF)) and later also entitled for *Ju'âlah* fee if there is any surplus. *Ju'âlah* is a fee imposed on performance basis.

With a great prospect to grow ahead, we really believe that this industry will grow faster than expected. With the current growth rate, and the opportunity from a very low *Takaful* and insurance penetration rate of Muslim countries, it has been seen as a profitable industry in the future. Despite all its great potential, it is also surrounded with challenges and defection that demand our efforts and focus to improve the industry. Hopefully, one day, *Takâful* will be a preferred *insurance* of the world, which promote justice and balance life.

Furthermore, *Takaful* practitioners, *Shari'ah* experts and government authorities should have mutual co-operation and understanding to plan the strategic solutions on the usage a particular model. There is a constant debate on the usage of the models, and this is always highlighted when *takâful* practitioners come together at conferences. Many have expressed their opinions that the *Shari'ah* councils should come up with a standard model for use globally. However, since different regions have their own laws, having a standard international model may be difficult to implement. Some do not accept certain models that do not agree with their laws. The jury is still out on when and how a standard global model will evolve.

As Abdul Rahim Abdul Wahab, Mervyn K. Lewis and M. Kabir Hassan (2007, p.395)

state that the *Takâful* system is still in the process of evolving, with a number of issues raised by various *Shari'ah* scholars. It is therefore desirable to encourage a process of discussion and advance alternative approaches with ideas that may come from anywhere around the world. The ultimate aim is to have a consensus model addressing as many current as well as future legal concerns as possible. Such a process seems to be a logical way to move forward and ensure that the *Takaful* at some stage is governed by a uniform consensus-based model.

At a global level, two basic models of *Takaful* are currently in operation. The *mudârabah* model is acceptable as long as the operator benefits only by sharing in the investment returns of the funds. However, there are some very serious reservations if it is applied to risk contracts with underwriting surplus being shared. These issues do not seem to have a solution and hence most operators now adopt the *wakâlah* model. The *wakâlah* model has much wider acceptance and is most suited to risk contracts. The *Shari'ah* concerns as well as some actuarial concerns in a typical *wakâlah* model were identified and some solutions proposed. Issues relating to the sharing in underwriting surplus in a *wakâlah* contract, and the issue of the risk premium and operator fee outlined here, deserve attention, as these can have an impact on the results of the fund and the operator. *Shari'ah* scholars need to have discussions with insurance professionals in an environment not associated with a particular *Takâful* client, as this could possibly lead to a bias on the part of the operator in explaining the intricacies of the insurance contracts and arrangements.

And also, *ijtihad* is an everlasting device for Islamic dynamism. Modern Islamic Jurists need to exercise their independent legal reasoning to guide the Muslim *Ummah* into the right path by exploring wrong ideas and

practices of the current commercial and financial transactions and to formulate new ideas and alternatives for the growth and survival of Islamic insurance system in the contemporary world.

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